BEFORE THE
TENNESSEE STATE BOARD OF EQUALIZATION

In Re:	American Healthways, Inc.	)	
	Personal Property Account No. 091496	)	Davidson County
	Tax year 2004	)	

INITIAL DECISION AND ORDER

Statement of the Case

Based on the information originally reported by the taxpayer, the Davidson County Assessor of Property ("Assessor") valued the subject property for tax purposes as follows:

Appraisal	Assessment
$12,853,584	$3,856,075

On October 7, 2005, the State Board of Equalization ("State Board") received a direct appeal by the taxpayer pursuant to Tenn. Code Ann. section 67-5-903(e) from the Assessor's rejection of an amended personal property schedule.

The undersigned administrative judge conducted a hearing of this matter on December 15, 2005 in Nashville. The appellant, American Healthways, Inc. ("American Healthways"), was represented by Paul D. Krivacka, Esq., of Adams and Reese LLP/Stokes Bartholomew (Nashville). Metropolitan Attorney Margaret O. Darby appeared on the Assessor's behalf.

Counsel for the parties filed post-hearing briefs during the week of January 30, 2006. With the permission of the administrative judge, Charles A. Trost, Esq., of Waller, Lansden, Dortch & Davis, LLP (Nashville), filed an Amicus Brief in support of American Healthways' position on behalf of HCA, Inc.; UnumProvident; International Paper Company; Nissan North America; Eastman Chemical Corporation; and Caterpillar Financial Services Corporation.

Findings of Fact and Conclusions of Law

Background. Though reminiscent of Brach & Brock Confections, Inc. (Hamilton County, Tax Year 1999, Initial Decision and Order, April 18, 2001) in that it involves the assessment of so-called "application" computer software, this case arrives at the State Board in a significantly different posture.

At issue in Brach & Brock was a complaint for back assessment/reassessment of a computer software package ("SAP") which the taxpayer had not listed on the tangible personal property schedule required by Tenn. Code Ann. section 67-5-903. The Hamilton County Assessor of Property, who had initiated the complaint, appealed the Hamilton County Board of Equalization's dismissal of it to the State Board. The parties stipulated that "the principal issue presented…is whether Brach's SAP software is properly classified as 'operational software' and therefore has been correctly assessed; or whether the SAP software is properly classified as 'applications software' and thus not subject to personal property taxation." In Brach & Brock, then, the assessor did not dispute the characterization of application software as a non-taxable

"intangible asset"; however, he believed the taxpayer's SAP to be operational software. Based on the evidentiary record, the administrative judge held otherwise.[1]

By contrast, the software in question here *was* reported by American Healthways on its original personal property schedule in GROUP 2 (Computers, Copiers, Peripherals, and Tools) for tax year 2004. But on September 1 of the following year, registered agent Carla Chester filed an amended rendition on the taxpayer's behalf that removed over $16 million in project costs related to application software.[2] Exhibit 1. Unlike *operational* software, Ms. Chester observed, *application* software was not listed in the Assessor's printed instructions among the types of items to be reported in GROUP 2. Exhibit 2. In a letter dated September 20, 2005, Commercial Supervisor Kenny Vinson notified Ms. Chester of the rejection of the amended schedule on the following grounds:

> To our knowledge, TCA 67-5-903 does not distinguish between operational vs. application software, but merely references peripherals concerning group 2. Also the county has reviewed the rules of the State Board of Equalization, particularly 0600-5-.04(3), which addresses types of tangible personal property which are not to be reported and found no mention of software.

Thus, whereas the burden of proof in Brach & Brock was on the appealing assessor, that burden unmistakably falls on the taxpayer in this proceeding. State Board Rule 0600-1-.11(1).

Testimony at the Hearing. Ms. Chester, a statewide practitioner who specializes in the taxation of personalty, knew of no other instance where a Tennessee assessor had not recognized the purported distinction between operational and application software. Yet according to Carina Brewer, Middle Tennessee Personal Property Coordinator for the State Division of Property Assessments, the assessment of computer software was a "gray area" that counties have not handled uniformly. She cited several examples of the self-reporting and assessment of application software.

As explained by American Healthways information technology employee Henry Rotter, application software consists of a copyrightable set of instructions that is designed to enable a computer to perform specific functions (e.g., word processing; spreadsheets). Although it is commonly stored in such media as magnetic tapes or compact discs, such software does not itself have physical attributes. Except with the consent of the copyright owner, a license to use application software is non-transferable.

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[1]Contrary to the assertions in Mr. Krivacka's Trial Brief (p. 7) and Mr. Trost's Amicus Brief (p. 6), the administrative judge did not categorically hold in Brach and Brock that application software is properly classified as intangible personal property. Indeed, in his initial order, the administrative judge remarked that he did "not necessarily share" the view that only operational software is assessable as tangible personal property.

[2]Ms. Chester was uncertain as to exact amount of installation costs deleted in the amended return.

A computer unequipped with application software is not without utility. Depending on the ability of the user, operational software may be modified so as to accomplish many of the same tasks. By Mr. Rotter's estimation, however, relatively few of the company's employees were highly skilled computer operators.

Michael Chester, a subordinate of Mr. Rotter, likened the formulation of software to the writing of literature. He confirmed that software was essential to the operation of a computer.

A. Dean Lewis, Appraisal Services Manager for the Assessor's Office, viewed the application software in question as an "intangible" that clearly enhanced the value of American Healthways' interest in the affected computers.

Contentions of the Parties. Mr. Krivacka emphasized that no law or rule of the State Board explicitly classifies application software as *tangible personal property*. At best, he argued, the statutory definition of that term is ambiguous and must be construed against the taxing authority. In his opinion, American Healthways justifiably relied on the implication in the Assessor's instructions that only operational software was reportable. Citing Tennessee Cable Television Association v. Tennessee Public Service Commission, 844 S.W.2d 151 (Tenn. App. 1992), Mr. Krivacka insisted that a legislative act or rulemaking proceeding would be necessary to change this longstanding policy.

While conceding that none of the disputed items was operational software, Ms. Darby maintained that all such items except certain personnel expenses and development costs were assessable as originally reported by the taxpayer. In her mind, the fact that the Tennessee General Assembly has deemed "prewritten computer software" to be tangible personal property under the Retailers' Sales Tax Act[3] was persuasive authority for the same treatment in the realm of property taxation.

Applicable Law. Article II, section 28 of the Tennessee Constitution provides that "all property real, personal or mixed shall be subject to taxation" unless exempted by the legislature. For tax purposes, property in this state is classified as real property; tangible personal property; or intangible personal property.

As defined in Tenn. Code Ann. section 67-5-501:

> (5) "Intangible personal property" includes personal property, such as money, any evidence of debt owed to a taxpayer, any evidence of ownership in a corporation or other business organization having multiple owners, and all other forms of property, the value of which is expressed in terms of what the property represents rather than its own intrinsic worth. "Intangible personal property" includes all personal property not defined as "tangible personal property";
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> (12) "Tangible personal property" includes personal property such as goods, chattels, and other articles of value which are capable of manual or physical possession, and certain machinery and

[3]*See* Tenn. Code Ann. section 67-6-102(a)(34)(B).

> equipment, separate and apart from any real property, and the value of which is intrinsic to the article itself.

Most *tangible* personal property that is used (or held for use) in a business or profession is assessable pursuant to Tenn. Code Ann. sections 67-5-901 *et seq*. Except as provided in Tenn. Code Ann. sections 67-5-1101 *et seq*., 67-5-1201 *et seq*., and 67-5-1301 *et seq.*, the legislature has not exercised its power to impose a tax on *intangible* personal property.

Analysis. The aforementioned "Instructions for Completing the Tangible Personal Property Schedule" do not have the force and effect of law; they are merely "intended as a general guide." Further, those instructions do not purport to identify **all** types of items which may be reportable under GROUP 2.

Nevertheless, as indicated in the Brach & Brock case, a taxpayer could reasonably infer from the instructions that application software is not considered to be tangible personal property in this jurisdiction. Indeed, non-reporting of application software is apparently a widespread, if not universal practice in this state.

In Commerce Union Bank v. Tidwell, 538 S.W.2d 405 (Tenn. 1976), the Supreme Court of Tennessee considered the issue of whether computer software was *tangible personal property* as then defined in the state sales and use tax law. Distinguishing the sale of software from the sale (or rental) of a motion picture film or phonograph record, the Court declared that:

> What is created and sold here is information, and the magnetic tapes which contain this information are only a method of transmitting these intellectual creations from the originator to the user. It is merely incidental that these intangibles are transmitted by way of a tangible reel of tape that is not even retained by the user.

538 S.W.2d 405 at 407.

Accordingly, the Court held that "the sale of computer software does not constitute the sale of tangible personal property…." *Id*. at 408.

To be sure, the Supreme Court's ruling in Commerce Union Bank v. Tidwell was largely negated by the enactment of Tenn. Code Ann. section 67-6-102(a)(34)(B), and is not necessarily binding authority with respect to property assessments. But there is no reason to suppose that the Court would reach a different conclusion in this kind of dispute. The testimony of the appellant's witness dovetailed with the Court's findings as to the nature and characteristics of application software. Moreover, if anything, the fact that the legislature has not redefined the term *tangible personal property* in Tenn. Code Ann. section 67-5-501 in the 30 years since the Commerce Union Bank decision suggests concurrence with it for property tax purposes.

Unlike the transferable tax credits that enhanced the value of the real property to which they were "irrevocably attached" in Spring Hill, L.P. v. Tennessee State Board of Equalization, 2003 WL 23099679 (Tenn. Ct. App. 2003), the application software in question clearly has value

independent of any particular computer in which it may be installed. Such separately-licensed software is not part of the "bundle of rights" associated with ownership (or lease) of the computer.

Order

It is, therefore, ORDERED that the subject property be valued in accordance with the amended tangible personal property schedule filed by the taxpayer's representative on September 1, 2005.

Pursuant to the Uniform Administrative Procedures Act, Tenn. Code Ann. §§ 4-5-301—325, Tenn. Code Ann. § 67-5-1501, and the Rules of Contested Case Procedure of the State Board of Equalization, the parties are advised of the following remedies:

1. A party may appeal this decision and order to the Assessment Appeals Commission pursuant to Tenn. Code Ann. § 67-5-1501 and Rule 0600-1-.12 of the Contested Case Procedures of the State Board of Equalization. Tennessee Code Annotated § 67-5-1501(c) provides that an appeal **"must be filed within thirty (30) days from the date the initial decision is sent."** Rule 0600-1-.12 of the Contested Case Procedures of the State Board of Equalization provides that the appeal be filed with the Executive Secretary of the State Board and that the appeal **"identify the allegedly erroneous finding(s) of fact and/or conclusion(s) of law in the initial order"**; or
2. A party may petition for reconsideration of this decision and order pursuant to Tenn. Code Ann. § 4-5-317 within fifteen (15) days of the entry of the order. The petition for reconsideration must state the specific grounds upon which relief is requested. The filing of a petition for reconsideration is not a prerequisite for seeking administrative or judicial review.

This order does not become final until an official certificate is issued by the Assessment Appeals Commission. Official certificates are normally issued seventy-five (75) days after the entry of the initial decision and order if no party has appealed.

ENTERED this 17th day of February, 2006.

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PETE LOESCH
ADMINISTRATIVE JUDGE
TENNESSEE DEPARTMENT OF STATE
ADMINISTRATIVE PROCEDURES DIVISION

cc: Paul D. Krivacka, Esq., Adams and Reese LLP/Stokes Bartholomew
Carla Chester, The Aegis Group
Metropolitan Attorney Margaret O. Darby
Jo Ann North, Davidson County Assessor of Property

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